GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee February 2, 2023

The Fed gives up the fight

Thomas Garretson, CFA – Minneapolis

With its latest policy move, the Federal Reserve appears to be acquiescing to the market's view that rate hikes are nearing an earlier conclusion, and at lower levels, than policymakers expected. We look at the reactions in the equity and bond markets, and the implications for the year ahead.

The latest round of policy meetings by major global central banks essentially played out in line with consensus expectations this week. For the Federal Reserve, that meant another downshift in the pace of rate hikes, with an increase of 25 basis points (bps) bringing U.S. interest rates to a target range of 4.50 percent to 4.75 percent. In the UK, a 50 bps bump took rates to 4.00 percent, and a 50 bps move in Europe brought rates to 2.50 percent.

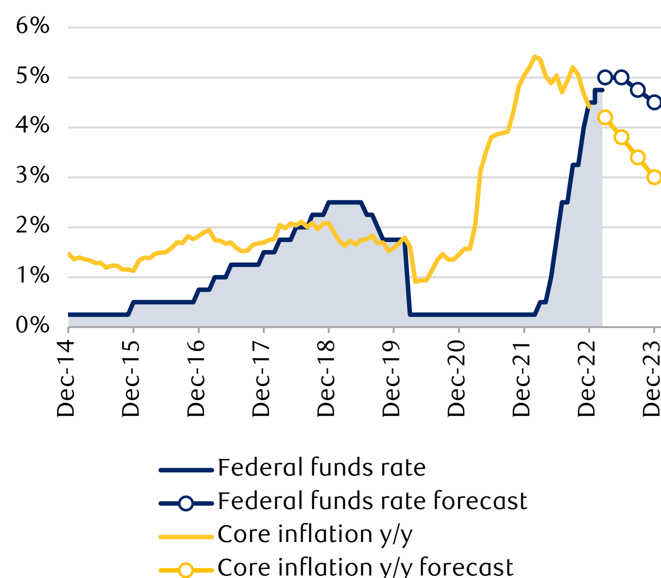
Though it appears increasingly certain that all three are nearing the end of their respective rate hike cycles, global markets typically take their cues from the Fed, and from that perspective we think the Fed's rate hike cycle might have just come to an end.

Job one done

At this point, we think it's clear that the Fed was behind the curve on inflation, playing catch-up over the course of 2022. But with the latest rate hike, that goal has finally been achieved. As the first chart shows, the U.S. policy rate now exceeds the most recent (December 2022) core inflation reading from the Fed's preferred barometer, the Personal Consumption Expenditures Index, for the first time since the last rate hike cycle.

We now know that inflation through the fourth quarter of last year was actually lower than the Fed had expected

The U.S. policy rate is now above inflation, setting the stage for the Fed to pause



Source - RBC Wealth Management, federal funds rate forecast based on RBC Capital Markets projections, core PCE inflation forecast based on Bloomberg consensus survey for January 2023

For perspectives on the week from our regional analysts, please see pages 3–4.

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at its December meeting. At that time, policymakers believed rates would have to rise as high as 5.25 percent this year. But at his post-meeting press conference, Fed Chair Jerome Powell noted early signs that "disinflationary pressures" are beginning to take hold; in our view, this could lay the foundation for the Fed to begin lowering its inflation forecasts when policymakers next update their economic projections at the March meeting—and, as a result, its rate hike forecasts as well.

Data dependency

The major changes in the Fed's latest official policy statement were removing verbiage around the pace of rate hikes and refocusing the outlook on the extent to which rates ultimately need to rise. Though Chair Powell already alluded to this last year, the new statement appears to confirm that the days of jumbo-sized rate hikes are indeed over, and that the Fed is now looking for an appropriate level at which to pause.

We would go so far as to say that the war on inflation is all but over, but note that questions about the true extent of tightness in the U.S. labor market remain unanswered.

And so it is jobs, not inflation (though the two are related) that may ultimately dictate when the Fed does indeed pause. With that in mind, markets won't have to wait long for confirmation that the Fed will raise rates "a couple more times"—as Powell stated he still believes will be necessary—or if a pause is coming sooner than expected.

The Feb. 3 Nonfarm Payrolls report is expected to show a slowdown in hiring, a modest uptick in the unemployment rate to 3.6 percent, and wage growth slowing to 4.3 percent y/y from 4.6 percent previously. But beyond these incremental numbers, we are also watching for the traditional annual revision report for 2022 that will be released alongside it, which may show that job gains in 2022 were not quite as robust as previously thought after being calculated with more complete and robust data.

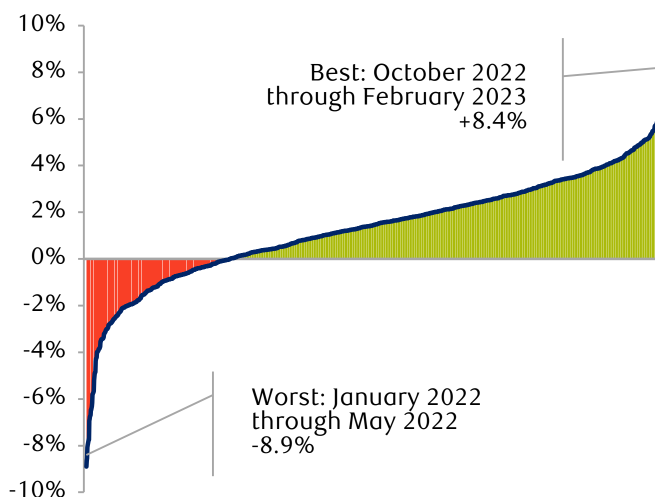
Quickly fading inflationary pressures paired with a softening labor market, on top of a recent rise in layoff activity, support our view that the Fed has already done enough and the pause is already here.

Don't just take our word for it

Markets have spoken. After a year in which Fed policymakers were quick, and successful, in quelling any market doubts about their resolve to raise rates aggressively in the war against inflation, Fed Chair Powell largely stood down from any such notion. We think this shift was likely the primary impetus behind this week's positive market reaction to the latest round of central bank rate hikes.

Treasury yields, specifically the benchmark 10-year Treasury note, dropped sharply again this week on fading rate hike and inflation fears, extending a decline that

Recent months have seen U.S. bonds' best run of the past 30 years, up over 8%



Source - RBC Wealth Management, Bloomberg US Bond Aggregate Index; shows rolling 15-week total returns since 1993 ranked from smallest to largest

began late last year. Since peaking at 4.24 percent on Oct. 24, 2022, the 10-year yield has slipped all the way to below 3.40 percent. As a result, 30-year fixed mortgage rates have also come off the boil; having touched levels beyond seven percent, they are now on the cusp of falling under six percent, according to Freddie Mac data.

As a result, the Bloomberg US Aggregate Bond Index, which comprises investment-grade bonds across a number of sectors, has just posted its best run of the past 30 years. As the average yield on the index has declined from a high of 5.2 percent last year to 4.2 percent this week, the average price of bonds in the index has jumped to $93 from $85 as the two move inversely, driving total returns of 8.4 percent over a period barely longer than three months.

Not to be outdone, the S&P 500 closed at 4,119 after the Fed's meeting on Feb. 1—its highest closing level since August of last year—and is now up over 15 percent from its Oct. 12, 2022 low.

The narrative has changed

While it has been a feel-good week for markets, and there are risks that the labor market could remain strong in the face of aggressive Fed action, we think markets are back in control. The Fed was successful last year in pushing back against markets that at times became too optimistic too early. Now it is markets that are saying the Fed has done enough, as pushback from the Fed wanes.

Markets will undoubtedly have plenty to worry about in 2023, but we have greater confidence now that the Fed and risks around overtightening will at least be one less thing.

UNITED STATES

Alan Robinson – Seattle

■ U.S. stocks continued their strong start to the year, with the S&P 500 posting its highest levels since August 2022. While "Fed Week" and earnings season are typically volatile periods for equities, investors cheered the combination of a slower pace of interest rate increases and earnings releases that were less bad than feared.

■ **The week started with about one-third of the S&P 500 by market cap having reported Q4 2022 earnings**, and will end with another one-third's results in the books as the tech giants report. Results have generally beaten expectations, and by midweek the quarter was on track to post aggregate revenue growth of 4% y/y and earnings declines of 4% as higher costs impacted profit margins.

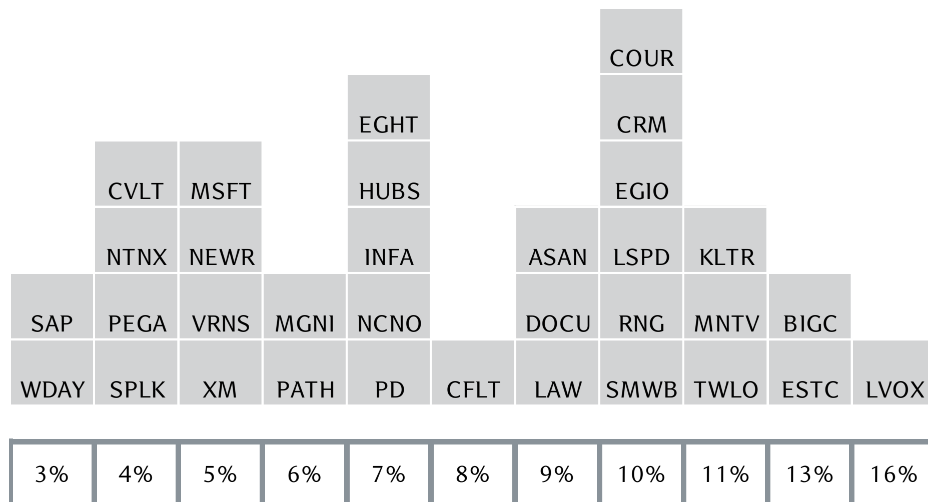
■ **The rally in stocks took the gains in the S&P 500 up to nearly 9% year to date, with a 6.2% gain in January alone**. Historical equity data support the mantra of "As goes January, so goes the year"; over the past 30 years there have been six instances of January gains above 4%, with an average return for the full year of 19%, compared to an average gain of 9% for all 30 years.

■ However, **many software workers had less to cheer in January** as the Tech sector continued to cut costs against a slowing demand environment. RBC Capital Markets, LLC Software Analyst Rishi Jaluria noted 33 publicly traded software companies had announced workforce reductions over the past four months, mostly in January. The most common figure was 10% of the workforce (see chart) across a range of small to large companies.

■ **These terminations have not yet worked their way through to the widely watched initial claims for unemployment benefits**, with this weekly data posting nine-month lows. This can be attributed to many laid-off workers jumping straight into new jobs, although with many of these long-term openings now being filled, wage growth is slowing. Employment Cost Index growth eased to 1% in Q4 2022 from 1.2% in Q3 2022, which hints at a Goldilocks scenario of a stable overall jobs market with softer wages.

Software companies lead the way in headcount reductions

Percentage of staff losses among selected publicly listed software companies, by stock ticker, since September 2022.



Source - RBC Capital Markets, RBC Wealth Management, company filings

CANADA

Mila Krunic & Matt Altro – Toronto

■ **The Canadian economy remains on a slowing path as a result of the Bank of Canada's (BoC) interest rate hikes** over the past year in response to excessive inflation. Real gross domestic product rose 0.1% m/m in November, according to figures published on Tuesday by Statistics Canada, with a preliminary estimate showing "no change" in December. There is, however, a clear loss of growth momentum towards the end of 2022. **The latest estimates imply the economy grew at an annualized rate of 1.6% in Q4 2022**, which will be updated near the end of February to reflect the official December reading. This is nearly half the growth seen in Q2 and Q3 2022, which came in at 3.2% and 2.9%, respectively. According to RBC Economics, 14 of 20 industrial sectors rose in November. Output in services-producing industries climbed 0.2% with a partial offset coming from a 0.1% dip in goods production. Retail trade fared poorly, recording a drop of 0.6% while restaurants and bars posted a 2.9% contraction.

■ **The S&P/TSX Composite Index has started 2023 on a strong note, ending January up 7.4% on a total-return basis.** As some of the sector laggards from 2022 recovered to various extents, leading the charge were stocks within Information Technology (+19.5%), Health Care (+14.6%), Materials (+10.7%), and Real Estate (+10.7%). More specifically, e-Commerce and Retail Apparels led the move higher as **risk appetite was bolstered by a softer tone from the BoC on monetary policy** at the January meeting where policymakers signaled they plan to pause rate hikes at current levels. Looking ahead, the economic backdrop remains somewhat subdued with consumer weakness emerging as a potential headwind. RBC Economics continues to expect household spending to decelerate in the coming quarters amid rising debt servicing costs. The S&P/TSX Composite is currently trading at 13.4x forward 12-month consensus earnings estimates, a 10% discount

to its long-term average, likely reflecting ongoing uncertainty regarding the economic outlook.

ASIA PACIFIC

Emily Li – Hong Kong

- **Spending by China residents in categories such as catering, tourism, and other in-person businesses recorded big jumps over the Chinese New Year holiday**. Data also show residents were more willing to travel and spend money following the end of strong zero-COVID restrictions. Meanwhile, the Purchasing Managers' Index (PMI) numbers suggest the economy has not fully recovered, as the Caixin Manufacturing PMI rose to 49.2 in January from December's 49 (a level below 50 indicates contraction). The official Manufacturing PMI, published by the National Bureau of Statistics (NBS), rose to 50.1 from 47 in December, the first expansion after three months of contraction. The Caixin index surveys smaller, private firms, while the NBS monitors larger, state-owned companies. Domestic manufacturers expressed increased optimism.

- **On Jan. 31, Samsung Electronics Co. (005930 KS Equity) made a surprisingly aggressive decision to keep capital spending at the same level as 2022**, implying the company will not pull back from the already intensive semiconductor competition. Chipmakers have been struggling with historically low memory prices, with consumers cutting back on chip procurements. Samsung expects a recovery in chips to begin in H2 2023, while smartphone demand would likely decrease in 2023.

The Asia Pacific semiconductor sector is on a gradual recovery path

Bloomberg Asia Pacific Semiconductors Index

Source - RBC Wealth Management, Bloomberg; data through 1/27/23

Samsung's announcement further boosted the Bloomberg Asia Pacific Semiconductors Index, extending the index's recent surge to a five-month high.

- **Southeast Asia manufacturers ramped up production and purchasing in January** due to more new orders along with the China re-opening, which might offset the global gloomy outlook. Prices are softening, supply chain disruptions are easing, and business confidence is rising across Asia. Thailand topped the region with a PMI of 54.5 in January, up from December's 52.5. The Philippines and Indonesia also posted January readings above 50.

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